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Langton Crescent
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24 April 2017

Subject: **Exposure Draft: Treasury Laws Amendment (2017 Measures No. 2) Bill 2017: superannuation reform package amending provisions**

Dear Laura

Mercer welcomes the opportunity to comment on the above exposure draft material.

We broadly support the proposed amendments, subject to a number of refinements that we understand will be recommended in the Financial Services Council submission on this matter and we do not propose to repeat here.

The main purpose of this submission is to raise a further issue regarding capped defined benefit income streams that we request be addressed in these amendments. Whilst this issue only affects a minority of defined benefit (DB) pension arrangements, it is nevertheless important that amendments be made to enable these pensions to be dealt with on an equitable basis.

The issue – reversionary spouse pensions with guarantee periods

Some DB lifetime pensions provide for a guarantee period – for example a retiree is entitled to a lifetime pension of 75% of the retiree's final average salary with a guarantee period of 10 years, with a reversionary spouse pension of two thirds of the retiree's pension (i.e. 50% of the retiree's final average salary) payable to a surviving spouse on the death of the retiree.

Under this design, if the retiree dies within the first 10 years and has a surviving spouse, the surviving spouse is entitled to the full retiree pension for the remainder of the 10 year 'guarantee period'. So, continuing our example above, if the retiree dies after 7 years, their surviving spouse would be entitled to a lifetime pension of:

- 75% of the retiree's final average salary for the remaining 3 years of the 10 year guarantee period (say $75,000 per annum), and
- 50% of the retiree's final average salary (say $50,000 per annum) thereafter.

(Indexation has been ignored for simplicity.)

We note that SIS sub-regulation 1.06(3) specifically allows for SIS sub-regulation 1.06(2) pensions to include such guarantee periods, generally up to 20 years. Hence such pensions may be classified as capped defined benefit income streams either because they meet the requirements of SIS sub-regulation 1.06(2) or because they meet the requirements of regulations issued under subsection (2) of Section 294-130 of the Income Tax Assessment Act 1997 (ITAA 1997) – noting proposed regulations to expand the range of capped defined benefit income streams under the transfer balance cap were issued for comment on 13 April.

In the case of such pensions that meet the requirements of SIS sub-regulation 1.06(2), the method for determining the credit for the reversionary pension to be counted against the surviving spouse's transfer balance cap on the death of the retiree (with a 12 month lag), is set out in subsection (2) of Section 294-135 of ITAA 1997. The problem that arises in these circumstances is that, under this sub-section, the transfer balance cap credit (the 'special value') would be calculated as:

16 x $75,000 = $1,200,000

i.e. it assumes the pension continues at $75,000 for the whole of the spouse's remaining lifetime**,** which is clearly an unfair outcome. This is because it is based on annualising the first pension payment made to the spouse, while in fact payments at this rate will continue for only a limited period.

A fairer approach

We suggest that a reasonably simple and much fairer treatment would be to calculate the 'special value' in these circumstances as:

(1) 16 x the ongoing lifetime pension of $50,000 = $800,000,

plus

(2) the remaining guarantee period x the additional guarantee amount of $25,000 pa

= 3 x $25,000 = $75,000

resulting in a transfer balance cap credit of $875,000 rather than $1,200,000.

To achieve this we suggest that:

(i) subsection (2) of Section 294-135 of ITAA 1997 be amended to allow different methods for calculating the special value to be specified in regulations, and regulations then be issued specifying the approach above for reversionary spouse pensions that are payable at a higher rate for a temporary period; and

(ii) the proposed regulations issued for comment on 13 April be amended to allow for this modified valuation method for relevant defined benefit pensions which qualify as capped defined benefit income streams under subsection (2) of Section 294-130 or by meeting SIS regulation 1.06(2) .

We suggest that it may also be desirable to provide for similar flexibility in subsection (3) of Section 294-135 of ITAA 1997, to provide an avenue for the Government to deal with anomalous circumstances that are identified in the special value of any income streams covered by that subsection, where it considers it appropriate to do so.

We recommend that Government issues a consultation draft of the regulations setting out the modified valuation method for reversionary defined benefit pensions with guarantee terms, both to ensure it properly caters for the relevant pensions and to provide an opportunity for funds to raise other pension designs with unusual features that may merit a different valuation method.

Who is Mercer?

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Mercer Australia provides customised administration, technology and total benefits outsourcing solutions to a large number of employer clients and superannuation funds (including industry funds, master trusts and employer sponsored superannuation funds). We have over $150 billion in funds under administration locally and provide services to over 2.4 million super members and 15,000 private clients. Our own master trust in Australia, the Mercer Super Trust, has around 230 participating employers, 213,000 members and $20 billion in assets under management.

Please contact me on 03 9623 5061 if you would like to discuss this submission.

Yours sincerely

Paul Shallue
Manager, Research & Policy